THE ECONOMY AND CONSTITUTIONAL CHANGE

by Donald J. Wright

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Confederation for the Twenty-First Century: THE ECONOMY AND CONSTITUTIONAL CHANGE

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Preface

Renewing Canada's Constitution will be a crucial challenge which British Columbians and all Canadians must meet in the coming months. While many British Columbians may be impatient with the continuing constitutional debate and may prefer to address pressing economic issues, the decisions we make in renewing the Canadian federation will ultimately have an impact in determining Canada's long-term prosperity. Indeed, one might view the constitutional reform process as an opportunity for both British Columbia and Canada to better position themselves to meet the demands of an increasingly globalized and competitive world economy. Therefore, from both economic and constitutional perspectives, British Columbians must ensure that they are adequately prepared to enter this fundamental reassessment of the Canadian federation.

The Government of British Columbia has identified consultation with British Columbians as the key component in preparing a British Columbia position on constitutional change. The Government recognizes that British Columbians, as strong and proud Canadians, want mechanisms for voicing their views on Canada's constitutional future. Last December, the Government of British Columbia established a Cabinet Committee on Confederation responsible for developing British Columbia's position on constitutional reform and its first priority was to initiate a process for soliciting the views of British Columbians. The Cabinet Committee published a background discussion paper in March 1991 to provide British Columbians with background information on constitutional issues and options to assist them in developing their own conclusions on constitutional reform.

The Cabinet Committee also believed that public consideration of the important issues would be stimulated by the release and circulation of a number of papers presenting the viewpoints of particular individuals. The Committee commissioned Melvin H. Smith, Q.C., long time constitutional advisor to the British Columbia Government, to write a paper setting out his recommendations on specific positions for the Government to consider in formulating its approach for upcoming constitutional negotiations, and this paper was published in May. The Committee also invited a number of British Columbians from various walks of life to submit papers outlining their perspectives on our Province's future role in Canada, and a volume containing the papers submitted is being published this month.

Given the vital importance of the economic dimensions of the constitutional question, the Committee requested that a paper be prepared which would focus consideration specifically on those dimensions. Accordingly, Mr. Don Wright was asked to write the present paper.

Mr. Wright is currently on contract to the Government of British Columbia as a policy advisor in the Intergovernmental Relations Branch. He has worked as a public servant for the Provinces of British Columbia and Saskatchewan in the areas of economic development, finance, education and international trade. His formal education includes a B.Comm. from the University of Saskatchewan, an M.A. (Economics) from the University of British Columbia, and a Ph.D. (Economics) from Harvard University. He also has taught economics at each of those Universities. Given Mr. Wright's range of experience and education, the Committee believed a paper written by him could provide some useful insights into the economic aspects of constitutional change.

The analysis and recommendations put forward in this paper are those of its author. The paper does not represent any official position of the Government of British Columbia. It is being published as input into the overall discussion of constitutional options, with the hope that it will stimulate the discussion that will help build a consensus on the appropriate direction to be taken by British Columbia.

In addition to the work of the Cabinet Committee on Confederation, the Legislative Assembly has established a Select Standing Committee on Constitutional Matters and Intergovernmental Relations. This all party committee will provide a forum for the people of British Columbia to offer their advice and recommendations to the Legislature. In concert with the work of the Cabinet Committee on Confederation, the findings of the Select Standing Committee will contribute to the development of the British Columbia approach to constitutional reform.

Cabinet Committee
on Confederation
July, 1991

Executive Summary

The starting proposition of this paper is that major improvements in Canada's economic performance could be achieved through changes in Canada's governing structures - that there are constitutional and institutional changes which would promote better government financial management, lower interest rates, more competitive Canadian industry, and better regional economic balance. This proposition is developed by first looking at the major economic problems challenging Canada and then proposing a set of constitutional/institutional changes that respond to those problems.

The Economic Problems Facing Canada

Three general economic problems are identified.

1. Canada is struggling in the race for international competitiveness.

Canada's recent relative performance with respect to factors that will determine whether or not it maintains one of the highest standards of living in the world has not been strong. In areas such as the relative cost competitiveness of our manufacturing sector, the rate of productivity growth, and the relative level of investment in knowledge-intensive industries, Canada's performance has been last amongst the seven largest industrial nations.

High interest rates and an expensive Canadian dollar have seriously damaged Canada's short-run competitive position. Beyond the effects arising from Canada's recent financial management, however, there is a fundamental problem in that Canada has not replaced, in any substantive sense, the model of economic development that was pioneered by Sir John A. Macdonald with his National Policy, which was based upon the export of natural resource products and a highly protected manufacturing sector.

Two major changes in the economic environment have seriously undermined the validity of this model. First, the reduction of international trade barriers since the end of the Second World War has undermined the very concept of a "national economy" upon which the National Policy was based.

The second change is the emergence of what has been labelled the "knowledge-based economy". The emergence of the knowledge-based economy means that wealth creation is becoming relatively more knowledge intensive and relatively less natural resource intensive. This directly undermines one of the foundations of Macdonald's National Policy - our natural resources become an increasingly insufficient base upon which to build an entire economy.

More fundamentally, the emergence of the knowledge-based economy changes how we should think about economic development - it requires a shift from an "output-centred" approach to economic development (i.e. promoting the output of particular industries or firms through such instruments as protective tariffs or subsidies) towards an "input-centred" approach (i.e. promoting the creation of particular inputs such as a well-educated and highly-skilled labour force, research and development, infrastructure, co-operative management-labour relations, and patient, "value-added" investors).

An important implication of these two major changes is that economic development will increasingly be a function of localized, rather than nation-wide, factors. On the one hand, the relevant market is the international one, so policies directed at affecting purchases within the national market will be less relevant. On the other hand, particular knowledge-intensive industries flourish because of a confluence of research, trained personnel, supportive capital markets and a consensus to co-ordinate these elements in a particular location.

The "new" model of economic development which these changes suggest would include the following elements:

i. a transfer downwards, as much as possible, of discretionary decision making with respect to the allocation of resources to particular types of support;

ii. a shift in emphasis from promoting outputs, through industry- or firm-specific protection and subsidies, to promoting particular types of inputs through support for R&D, education and training, and infrastructure; and

iii. constraints on provincial "beggar-thy-neighbour" policies which reduce the ability to develop internationally competitive industries.

2. Government financial management has resulted in a combination of high government deficits and debt, and high interest rates.

The legacy of Canada's financial management over the past fifteen years can be summarized as: high government deficits and debts, high interest rates and, at least temporarily, a high value of the Canadian dollar relative to the level consistent with competitive Canadian industry.

The damage that deficits do to governments' ability to fulfill the roles required of them is straightforward. Deficits add to the level of debt carried by a government, which adds to the interest expense that must be paid. This in turn, reduces a government's capacity to spend money on programs

In addition to undermining the long-run capacity of governments to play positive and active roles in pursuing public objectives, government debts and deficits exact a significant economic cost by leading to higher interest rates. The result in the late 1980's and early 1990's has been a level of real interest rates (interest rates less the rate of inflation) that is high relative both to historical Canadian experience and to the rates of Canada's major trading partners. The high interest rates resulting from the debt/deficit problem are compounded by the Bank of Canada's desire to achieve a lower rate of inflation in Canada than in the U.S., which in turn has led to an over-valued exchange rate. The high interest rates and high value of the Canadian dollar has seriously undermined Canadian industry's ability to compete in international markets.

The cause-and-effect relationship between high government deficits and high interest rates is not purely one way. The costs of servicing the high levels of debt resulting from cumulative deficits are a function of interest rates. A Catch-22 situation thus seems to have developed - lower interest rates are required to lower the deficit, but a lower deficit is required to lower interest rates. A critical component in resolving this impasse will be to strengthen the credibility of government's long-term commitment to deficit reduction and low inflation.

3. Regional disparities in economic performance have remained wide despite explicit government policies to reduce them

While there are limits to how much government policy can alter the regional structure of the Canadian economy, and the disparities associated with it, there are significant issues that can be substantively addressed.

The general lessons of the changes in the economic environment - the need for the shift in emphasis from outputs to inputs and to shift discretionary decision making downwards as much as possible - are obviously relevant in the context of regional development.

Because of the dominant share of central Canada in the national economy, its economic performance dominates the "average" performance of the national economy. When central Canada's economy is overheating, the national economy will, "on average", be overheating - regardless of the actual health of the regional economies. When fiscal policy (government taxation and spending) does not appropriately stabilize the economy of central Canada, the

regional economies will bear the extra burden of an inappropriate monetary policy. In particular, the regional economies will pay part of the price for over-heating in central Canada.

National policies have a profound impact on the distribution of economic activity in Canada. While we argue for a transfer of discretionary policy down to the regional level, it will still be the case that important "framework" policies must be developed at the national level - for example, in international trade, transportation, and telecommunications. It is important for the regions to have a greater explicit voice in the design of these national policies.

Improving Canadian Economic Performance

In response to the problems identified above, constitutional and/or institutional modifications in three areas are proposed.

1. Restructuring the approach to economic development.

The elements identified for a "new" approach to economic development call for a decentralization of decision making with respect to discretionary spending, but within a set of rules, or constraints, which strengthens the Canadian common market and leads governments to promote economic development through support of inputs rather than outputs.

To achieve the desired decentralization of decision making, it is proposed that the division of powers in the Constitution be redefined so that the following jurisdictional areas are defined as being ones of federal-provincial concurrency with provincial paramountcy (CPP):

- regional and industrial development;
- manpower/training; and
- research and development/science policy.

In general terms CPP means that both levels of government may operate in a particular area side-by-side unless a provincial government chooses to exercise its paramountcy - federal legislation would not be applicable and the federal government would not spend any money in the particular province, with the province receiving financial compensation.

The mechanism proposed for developing and enforcing a set of rules is patterned on recommendations put forward by the Macdonald Royal Commission in 1985. A federal-provincial Council of Ministers responsible for economic development would be established. This Council would be responsible for developing a "Code of Economic Conduct" which would be an enforceable agreement to eliminate barriers to interprovincial trade and mobility of labour and capital, and to constrain the types and amounts of industry- and firm-specific subsidies that governments use for economic development. In particular, the objective with respect to the subsidies part of the Code would be to shift the emphasis away from outputs in favour of inputs. This Code would thus be a vehicle both to make the Canadian common market more complete and to effect the appropriate change in the approach to economic development.

2. Measures to Promote Prudent Financial Management

The root of the problem with respect to government financial management lies in the differing time horizons between what is prudent from a political point of view and what is prudent from a financial point of view - there is a divergence between the time horizon applicable to the "electoral cycle" and that applicable to the "debt cycle". It takes seven to ten years for the cumulative increase in debt to raise interest expenses enough to outweigh an initial increase in the deficit. This seven-to-ten-year debt cycle is contrasted with a political cycle that is never longer than five years, and gets steadily shorter each day after an election.

The remedy proposed is to put a "prudent manager rule" into the Constitution that requires provincial and federal governments to

maintain a structure of spending and taxation that is sustainable over the long run. Such a rule would require governments to address debt/deficit situations that are clearly unsustainable.

The adoption of a strong prudent manager rule would, in addition to maintaining government's capability to play a major and positive role, result in lower interest rates. The Catch-22 situation described above would be reversed - lower interest rates and lower deficits would become mutually reinforcing. The critical component in bringing this about is the credibility of the commitment to prudent financial management - hence the need for a strong prudent manager rule in the Constitution.

A possible further step which would increase the credibility of the commitment to prudent financial management would be to increase the independence of the Bank of Canada from the federal government. By doing so, the fear that the Bank may be subject to political pressure to inflate would be further reduced. Such a change would require careful consideration as to the appropriate objectives for the Bank. In particular, it is argued that, for a small trading economy like Canada, stability of the exchange rate should be considered as important as stability of the domestic price level. It should also be clear that dealing with the debt/deficit problem is a necessary prerequisite for a more independent central bank - without a solution to the debt/deficit problem, an independent monetary policy will not be sustainable over the medium to long term.

An additional benefit of a prudent manager rule would be that, by forcing provincial governments to ensure that their budget structures are sustainable, provinces would take more responsibility for stabilizing their own economies. In particular, overheating provinces would have to adapt restrictive fiscal policy, reducing the need for an overly restrictive monetary policy which places a further burden on weaker regions.

3. Strengthening Regional Input into National Policies

The final proposed change is for a formal provincial role in developing selected national policies. In general terms, what is envisioned is that the federal-provincial Council of Ministers described above would have real decision-making powers assigned to it. Decisions would be reached by qualified majority (eg. approval by the federal government and two-thirds of the provinces making up fifty percent of the population). In addition to responsibility for the Code of Economic Conduct discussed above, the Council could have powers over such areas as ratification of international trade treaties, selected parts of telecommunications and transportation policy, and ratification of federal appointments to the Board of the Bank of Canada.

I. Introduction

There are a number of different perspectives from which to consider the question of how Canada should be structured and governed. This paper takes a look at this question from one very important perspective - the economic one. In particular, it is motivated by the question: How could we improve the economic performance of Canada through changes in the constitutional and institutional underpinnings of its governments?

The definition of economic performance used here reflects a range of related objectives:

- a growing standard of living;
- the creation of sufficient numbers of high-quality employment opportunities;
- the capacity to sustain government expenditures; and
- an equitable distribution of economic benefits across individuals and regions.

It is not plausible to think that a nation's constitutional and institutional architecture could mandate particular levels of economic performance. That architecture can have, however, profound effects on the nature and structure of government economic policy, and, by so doing, significantly affect the nation's economic performance. Indeed, the starting proposition of this paper is that major improvements in Canada's economic performance could be achieved through some renovations of our governing structures. While there may be a tendency for Canadians to think that constitutional discussions are obscure and largely irrelevant to the bread and butter issues of most importance to them, it is the position here that there may be profound benefits, such as lower interest rates and a higher standard of living, arising from appropriate changes in the way the country is governed.

The argument of the paper is advanced as follows. In Section II the major economic problems challenging Canada are discussed. In Section III a set of changes in governance on economic matters is outlined as a response to the challenges identified earlier. Finally, some concluding remarks are made in Section IV.

II. Challenge: The Economic Problems Facing Canada

There are three general economic problems facing Canada that should be considered:

1. Canada is struggling in the race for international competitiveness;
2. Government financial management has resulted in a combination of high government deficits and debt, and high interest rates;
3. Regional disparities in economic performance have remained wide despite explicit government policies to reduce them.

Despite the fact that we identify and will discuss separately these problems, the discussion below will make it clear that they are interrelated and reinforce one another.

1. Canada's International Competitiveness

The health of Canada's international competitiveness has been the subject of considerable policy discussion recently. In particular, there is widespread concern that Canada is not keeping pace with its trading partners in the race for global competitiveness. What is meant by "competitiveness" can mean somewhat different things to different people, but it is generally used as shorthand for a related set of factors:

- cost competitiveness;
- a high rate of productivity growth;
- a high quality labour force;
- high levels of investment in new plant and equipment;
- rapid application of new technology;
- a high level of investment in research and development; and
- evolution from low value-added industries to high value-added ("knowledge-intensive") industries.

Competitiveness is not synonymous with low wages. Taken together, the factors above determine whether or not a country will be able to sustain a "high wage - high value-added economy". Successful economies, such as Japan seem to be on such a path.

In short, the concern about international competitiveness is really a concern about "tomorrow's prosperity". Will we continue to be able to sell our products in world markets, improve our standard of living, and generate "good jobs" in "good industries"?

The box on the next page outlines selective evidence that in a number of key areas - cost competitiveness, productivity growth, and investment in research and development - Canada has not performed well in comparison with other major industrial economies.

In the next subsection we will look at the issues surrounding Canada's financial management - the level of government debts and deficits, interest rates and the external value of the Canadian dollar. High interest rates and an expensive Canadian dollar seriously damage Canada's short-run competitive position. Canada's high interest rates put Canadian industry at a severe disadvantage in investing in new plant and equipment, new technology or market development. A value for the Canadian dollar in excess of what can be justified by its purchasing power directly reduces the cost competitiveness of Canadian industry. Taken together, the high interest and exchange rates go a long way to explaining why Canada entered into a significant recession in 1990 well before its major trading partner did.

Beyond the effects arising from Canada's financial management, however, there is a fundamental problem in that Canada has not replaced, in any substantive sense, the model of economic development that lay behind Sir John A. Macdonald's National Policy.

In essence, Macdonald's model of economic development consisted of two elements:

- Canada's internationally-competitive sectors were the natural resource-based ones; and
- a national economy would be developed by subsidizing the development of a manufacturing sector and east-west commerce through explicit or implicit taxes on the resource sector - principally with railway land grants and the protective tariff.

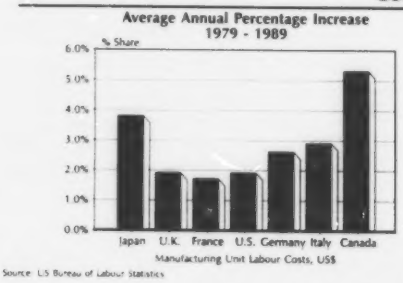
As recently as the 1980's, this model was still being used to frame national economic development policies - the National Energy Program, with its heavy federal taxation of the energy resource sector, its subsidization of energy consumers through lower prices, and its strategy of promoting domestic industrial activity through energy mega-projects, was a direct descendent of Macdonald's National Policy.

The problem with this model is that, because of two major changes in the economic environment, it is no longer valid.

First, the reduction of international trade barriers since the end of the Second World

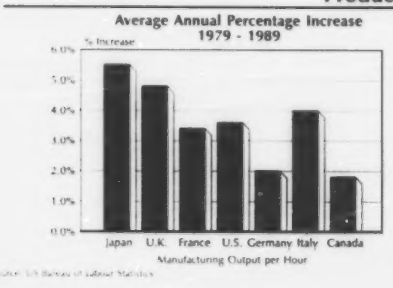
SELECTED INDICATORS OF CANADA'S COMPETITIVE PERFORMANCE.

Figure 1
Costs



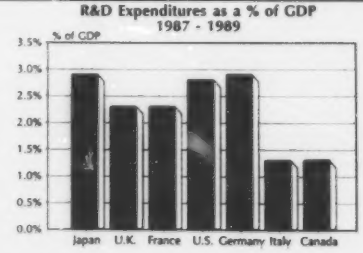
Source: US Bureau of Labour Statistics

Figure 2
Productivity



Source: US Bureau of Labour Statistics

Figure 3
Research & Development



Source: Organization for Economic Cooperation & Development

Figures 1 through 3 provide an impressionistic scan of Canada's competitive position relative to the six other major industrial economies.

Figure 1 shows the average annual percentage growth in manufacturing unit labour costs, measured in a common currency, over the period 1979-89. A higher percentage represents a decline in cost competitiveness. Canada's performance was the worst of these seven countries. The higher figure for Canada relative to the United States means that Canada's labour cost competitiveness relative to the United States fell by almost 40 percent between 1979 and 1989. Virtually all of this decline occurred over the period 1986-89, and approximately two-thirds of that decline was a function of the appreciation of the Canadian dollar over those three years.

Figure 2 shows the average annual percentage growth in manufacturing productivity between 1979 and 1989. Over the long run, productivity growth is the basis for increases in a country's standard of living. Canada's performance was the weakest of the seven countries.

Figure 3 shows total research and development expenditures as a percentage of Gross Domestic Product. This is one measure of the rate at which a country is investing in the "knowledge-based economy". By this measure, Canada was tied with Italy in last spot.

While these indicators suggest that Canada is facing competitive problems, this should be kept in perspective. Per capita output in real terms (i.e. correcting for differences in prices) puts Canada in second place amongst these countries (the U.S. is first). We are still "rich". The concern about competitiveness is whether we will remain so.

War, in which Canada has been a willing participant and beneficiary, has undermined the very concept of a "national economy". The notion that the relevant market is now international, not national, has been commonly labeled "globalization". In Canada the value of goods exported to the rest of the world exceeded the value of goods traded interprovincially as early as the 1970's, and the relative importance of external trade grew during the 1980's.

The second major change relates to the emergence of what has been labeled the "information society", the "post-industrial age" or the "knowledge-based economy". The emergence of the knowledge-based economy means that wealth creation is becoming relatively more knowledge intensive and relatively less natural resource intensive. This directly undermines one of the foundations of Macdonald's National Policy - our natural resources become an increasingly insufficient base upon which to build an entire economy. More fundamentally, the emergence of the knowledge-based economy changes how we should think about economic development.

The emergence of the knowledge-based economy requires a shift from an "output-centred" to an "input-centred" approach to economic development. An output-centred approach promotes the output of particular industries or firms through such instruments as protective tariffs or subsidies, implicitly assuming that the appropriate supply of inputs either already exists or will be automatically created. An input-centred approach to economic development promotes the supply of particular inputs - a well-educated and highly-skilled labour force, research and development, infrastructure, constructive management-labour relations, and patient, "value-added" investors, implicitly assuming that these inputs will form the basis for competitive industries. The proposition here is that the balance between these two approaches needs to be tilted significantly towards the input-centred one.

An important implication of these two major changes is that economic development will increasingly be a function of localized, rather than nation-wide, factors. On the one hand, the relevant market is the international one, so policies directed at affecting purchases within the national market will be less relevant. On the other hand, particular knowledge-intensive industries flourish because of a confluence of research, trained personnel, supportive capital markets and a consensus to co-ordinate these elements in a particular location - Silicon Valley in California, for example.

The "new" model of economic development which these changes suggest would include the following elements:

i. a transfer downwards, as much as possible, of discretionary decision making with respect to the allocation of resources to particular types of support. Because localized factors will determine economic development, the governments closer to the particular localities will, other things being equal, have the best understanding of economic development possibilities and requirements, the strongest commitment to successful outcomes, and the greatest ability to organize the local co-ordination and co-operation required;

ii. a shift in emphasis from promoting outputs through industry- or firm-specific protection and subsidies to promoting particular types of inputs through support for R&D, education and training, and infrastructure; and

iii. a more complete recognition that the orientation for economic development should be that of capturing a share of the international market, not the national market. A specific implication of this is the need for significant constraints on "beggar-thy-neighbour" policies that attempt to shift economic activity from one province to another through such policies as barriers to interprovincial trade and subsidy bidding wars for particular firms.

This last point requires further discussion. An explicit recognition of the need for an international, as opposed to a national, focus

highlights two reasons why beggar-thy-neighbour policies need to be constrained. First, those policies really only make sense in the context of trying to protect or increase a share of the national market. Aside from the inefficiency and waste engendered by these policies, they skew the policy maker's orientation away from the international market.

Second, the overall trend in international trade rules appears to be towards ever stricter constraints on industry- and firm-specific subsidies and protection. It is difficult to see how international competitiveness in this environment could be advanced by allowing such behavior in the context of interprovincial trade. The minimum that would seem to be required would be that the rules governing interprovincial trade be at least as liberal as the rules governing international trade.

A final point worth noting here is that, to a considerable extent, elements ii. and iii. will be complementary. They both call for a reduction in industry- and firm-specific subsidies and protection. Furthermore, increased investments made in R&D, training and education by any particular province will generally not reduce economic opportunities in other provinces, particularly in the context of an orientation towards international markets.

2. Canada's Financial Management

The legacy of Canada's financial management over the past fifteen years can be summarized as: high government deficits and debts, high interest rates and, at least temporarily, a high value of the Canadian dollar relative to the level consistent with competitive Canadian industry. It is difficult to consider any of these elements in isolation because of the significant interrelations amongst them, but the most logical starting point is to look at the debt/deficit problem.

The Debt/Deficit Problem

Perhaps no other issue of public policy has received more attention and concern over the past decade than the level of government debt and deficits. Furthermore, it is hard to imagine an issue over which there is so much, virtually universal, consensus amongst analysts with respect to its implications and what, in general terms, needs to be done. And yet, over the past decade, the levels of government debt and debt-servicing costs continued to rise, not only in absolute terms but also relative to government revenues and the overall size of the economy.

The damage that deficits do to governments' ability to fulfill the roles required of them is straightforward. Deficits add to the level of debt carried by a government, which adds to the interest expense that must be paid. This, in turn, reduces a government's capacity to spend money on programs.

The growth in government debt is particularly dangerous when the debt is growing at a rate faster than the rate of growth in the economy, which is what has been happening in Canada from 1975 through the present. The box on the next page illustrates how the federal government's net debt has risen over the past 20 years in absolute dollar terms and as a percentage of national income (as represented by Gross Domestic Product - GDP). Twenty years ago federal government debt represented 21 percent of Canada's GDP; today the equivalent figure is 57 percent. Even assuming that interest rates are unaffected by this increase in debt (it is argued below that interest rates are higher because of government deficits), the costs of servicing this increase in the relative size of government debt represents something like $27 billion. This is $27 billion that is not available for education, health care, investment in research and development, regional development, or any other government program.

In absolute terms, the federal government's debt is significantly larger than the aggregate value of provincial government debt, and there has not been the same dramatic increase in the provincial debt/GDP ratio over the past twenty years. This masks, however, two serious grounds for concern with respect to

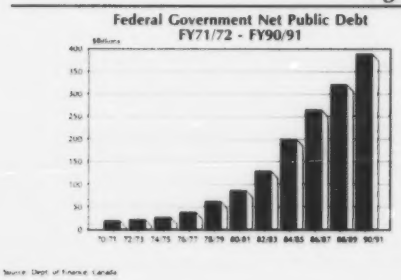
provincial finances. First, the aggregate figures for the provinces hide the fact that some individual provinces already have extremely precarious levels of debt.

Second, there is a cause for concern which extends generally over all the provinces in that costs in the program areas for which they are responsible - most notably in health - are escalating rapidly, making them very vulnerable to a downturn in revenue growth. Taken together, these two concerns suggest there is a very real risk that the current recession will do to provincial finances what the 1981-82 recession did to federal finances.

In the extreme, the problem can become explosive. If the debt relative to the size of the economy becomes large enough, it becomes impossible for a government to keep pace even with the increase in debt-servicing costs. If most of the debt is denominated in domestic currency, the government may try to "monetize the debt" (in essence, financing the deficit by having the central bank print money), launching the economy into hyperinflation. If most of the debt is denominated in foreign currency, the country will be pushed into some kind of default on its foreign debt. We have seen both of these circumstances occur throughout the world, particularly in Latin America. While the comparison to Latin America might seem extreme, it is sobering to note that, in the early part of this century, Argentina had one of the highest standards of living in the world, and was widely believed to be on the verge of becoming a major world economic power. Then, however, governments began promising and spending more resources than available revenue would allow, and the debt explosion began.

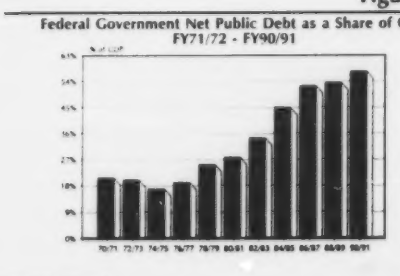
THE GROWING DEBT PROBLEM

Figure 1



Source: Dept. of Finance, Canada

Figure 2



Source: Dept. of Finance, Canada

Figure 1 shows how the net public debt of the federal government has grown over the past 20 years from slightly less than $20 billion to almost $400 billion.

A more meaningful measure of the size of the debt is to show it relative to the size of national income. Such a measure is displayed in *Figure 2*, which shows that net federal public debt as a percentage of national income - Gross Domestic Product (GDP) - has risen from just over 20 percent to almost 60 percent in the past 20 years.

The significance of a growing Debt/GDP ratio is that it means a growing portion of national income must be devoted to paying interest on the public debt. Twenty years ago interest costs on the public debt represented 1 percent of national income. Now they are in excess of 5 percent. The difference represents a portion of national income that must be collected through taxation but is not available for expenditure on government programs.

There are two types of arguments still made by some in an effort to counter the case for deficit control. One of these is that the argument for deficit control is really just a trojan horse for attacks on government spending in general - that it is really a disguise for a "small government" agenda. Ironically, this argument should be stood on its head. Deficit control is not a question of a greater or a lesser role for government - it is a question of whether or not the capacity of government to play an active role in society will be maintained. Thus, it is those who are most in favour of a major role for government who should be most concerned about deficits.

The other argument made against the case for deficit control is a version of the one that tries to claim "we only owe it to ourselves, so it is not a problem". This argument is wrong for two reasons. First of all, it is not the case that we only owe it to ourselves - Canada's level of foreign indebtedness is amongst the highest in the world. The second flaw with this argument is that, even if we did owe it only to ourselves, this is quite beside the point. The concern about debt is not a question of maintaining the aggregate purchasing power of the economy (which is what the "we owe it to ourselves argument" is really based upon), but of maintaining the purchasing power of government. Taxpayers distinguish between money they can spend themselves and money that government taxes away and spends on behalf of them. The evidence is that politically, if not economically, there is a limit to the level of taxes the public is willing to pay.

The Interaction with Interest Rates

In addition to undermining the long-run capacity of governments to play positive and active roles in pursuing public objectives, government debts and deficits exact a significant economic cost by leading to higher interest rates.

There are three, interrelated ways in which debts and deficits lead to higher interest rates:

- government deficits, other things being equal, raise the level of purchasing power in the economy. This will require the central bank to engineer higher interest rates than would have been necessary in the absence of government deficits, in order to achieve whatever level of purchasing power is consistent with its objective for the economy's inflation performance;
- the debt problem facing the federal government holds the risks, as suggested above, that a point will be reached where the government cannot (will not?) raise taxes and/or reduce expenditures by enough to continue servicing the accumulated debt. Thus the possibility exists that some government may try to get itself out of its debt problems by monetizing the debt. This would lead to a significant increase in inflation - in the extreme a Latin American situation could develop. To compensate for the risk that this might happen, investors require a premium to hold debt denominated in Canadian currency; and
- because Canada is a major international debtor, and continues to run significant deficits on its current account, Canadian interest rates must be high enough to attract and maintain international investors.

The result has been a level of real interest rates (interest rates less the rate of inflation) that is high relative both to historical Canadian experience and to the rates of Canada's major trading partners. This undermines Canadian industry's ability to compete in international markets, as was pointed out in the previous section.

The problems arising from the debt-interest rate connection have been exacerbated by the fact that, for the past four years, the Bank of Canada has been more ambitious in its objective for inflation performance than it had been previously. Until the most recent federal budget the Bank did not articulate a particular target for inflation, but spoke obscurely of "price stability". What has become clear, however, is that the Bank of Canada has an objective

which represents a lower rate of inflation than is expected to prevail in the United States. This has been made explicit in the recent federal budget, in which the projected average rate of inflation over the period 1992-96 is more than one third lower in Canada than in the United States (2.4 percent versus 3.8 percent). Perhaps more significantly, this objective is implicit in the fact that the Bank of Canada has engineered a rise in the Canadian dollar since 1986 to a level that exceeds its competitive level relative to the U.S. dollar - a development that is only rational in the context of a desire to have a lower rate of inflation in Canada than in the U.S.

The advisability of pursuing this ambitious objective for a small trading economy like Canada is questionable (see box below), but the important point here is that it is making an already serious problem worse.

High government debts and deficits lead to higher interest rates, but the cause-and-effect relationship is not purely one way. The costs of servicing the high levels of debt resulting from cumulative deficits are a function of interest rates - every 1 percent increase in interest rates increases the cost of servicing the federal debt by about $2 billion per year in the first year after the increase and by about $3 billion per year five years after the increase.

What seems to make the easing of interest rates difficult in this context is the nervousness of money markets that the government may try to inflate its way out of its fiscal problem. A too rapid reduction in interest rates might be perceived as sending that signal, precipitating a sell off of the Canadian dollar and touching off just such a round of inflation. A Catch-22 situation thus seems to have developed - lower interest rates are required to lower the deficit, but a lower deficit is required to lower interest rates. Given uncertainty about the future behaviour of the government and the central bank, a critical component in resolving this impasse will be to establish the credibility of the long-term commitment to low and stable inflation.

Summary

To summarize this subsection on financial management, it has been argued that:

- Canada currently has a debt/deficit problem that endangers the capacity to sustain government programs;
- this debt/deficit problem also contributes to higher interest rates, with negative effects on

WHAT TYPE OF STABILITY SHOULD THE BANK OF CANADA BE TARGETING?

"We have a market economy, and one of its pillars is the institution of money and monetary exchange... The prices of goods and services are set in money terms. We keep economic score and frame our day-to-day and longer-term decisions in money terms. Damaging that institution, as inflation must, introduces needless uncertainty and thereby makes our economy less efficient and less productive. It also injects inequity, hurting some groups of people to the benefit of others, and for no socially worthwhile purpose."

John Crow, Governor
Bank of Canada

Price stability is an important objective for a country's central bank, and issue is not taken with that proposition.

There are, however, two types of price stability with which a central bank should be concerned. One is the purchasing power of money in terms of domestic goods and services - the conventional target for inflation control. The other is the purchasing power of money in terms of foreign goods and services - the exchange rate. In the globalized economy, and particularly in the case of a small trading economy such as Canada, economic decisions may be as affected by instability in the exchange rate as by instability in the rate of inflation. When important transactions are increasingly international, rather than national, it becomes increasingly important to provide for stability in those transactions - that is, to provide for more stability in the foreign value of the Canadian dollar.

In setting ambitious targets for low inflation - the targets established for the Canadian rate of inflation in the recent federal budget are significantly lower than the rates of inflation projected for the United States - the Bank of Canada is concentrating on one type of price stability at the expense of the other, with negative effects on the competitiveness of Canadian industry. It seems timely to ask if the Bank should not strive for more of a balance between the two types of stability.

the performance of Canadian industry;

- the high interest rates resulting from the debt/deficit problem are compounded by the Bank of Canada's desire to achieve a lower rate of inflation in Canada than in the U.S.; this in turn has led to an over-valued exchange rate, causing significant competitive problems for Canadian industry;
- high interest rates feed back into the debt/deficit problem by raising debt-servicing costs; and
- a simultaneous reduction in deficits and interest rates would be made easier if investors were convinced of the long-term commitment to deficit reduction and low inflation.

3. Regional Development

One of the major issues with respect to economic development in Canada has been the promotion of "regional development". The concern for regional development arises from one of the strong defining Canadian values - a desire for greater equity across regions. The notion of regional development encompasses three, related but somewhat distinct objectives:

- improving income levels in poorer regions;
- enhancing the economic base of poorer regions; and
- improving the economic stability of natural resource-dependent regions through efforts to stabilize the resource industries, to increase their value-added, and to diversify away from them.

It is worth noting that this last objective suggests that even the "have" provinces of Alberta and British Columbia have an interest in regional development as it is defined here.

The success of government policy with respect to these objectives has been mixed. There has been some narrowing in per capita income levels between the poorer regions (in particular, the Atlantic Provinces) and the national average over the past twenty-five years. For the most part, however, this appears to have resulted from income transfer programs, rather than from any significant enhancement of the economic bases of the poorer regions. There also does not appear to have been a significant diversification of the economic base away from natural resource industries in the regions outside central Canada.

In a survey of the pattern of regional economic development of Canada, Mario Polese summarized the evidence as follows:

> "The regional structure of the Canadian economy, and the income disparities which accompany it, show a high degree of stability over the long run. The broad regional patterns and trends are well-defined.
>
> • • •
>
> The obvious conclusion to be drawn from these results is that there are definite limits to the capacity of public policy to alter long-run patterns. Location does matter; geography cannot be legislated away."*

Having said that, Polese did not argue for abandoning the regions to their fates, but argued instead for a continuation of the search for better regional development policies. There are several points that might inform such a search in the context of how Canada should be governed on economic matters.

In Section II.1 it was argued that the emergence of the knowledge-based economy suggested a shift in emphasis from promoting outputs to promoting inputs. This is particularly relevant in that much regional development policy in Canada has traditionally taken the form of firm-specific subsidies to locate or expand in a particular region. It was also argued that the emergence of the knowledge-based economy, in conjunction with globalization, suggested that discretionary decision making should be transferred downwards as much as possible.

*Polese, Mario, "Patterns of Regional Economic Development in Canada: Long-Term Trends and Issues". In William J. Coffey and Mario Polese (ed.). Still Living Together: Recent Trends and Future Directions in Canadian Regional Development. Montreal: The Institute for Research on Public Policy, 1987, pp. 22-23.

Beyond these points arising from the discussion above, there are two other issues that should be discussed - the regional effects of government financial management and the need for greater regional input into national policies.

Financial Management and the Regions

In the subsection on financial management, it was argued that high government debts and deficits led to higher interest rates. This will have a greater negative effect on a region to the extent that the region is already in weaker economic shape and/or its industry is more capital-intensive than average.

There is another dimension to the issue arising from the dominant share of central Canada in the national economy. In particular, the economic performance of central Canada dominates the "average" performance of the economy. When central Canada's economy is overheating, the national economy will, "on average", be overheating - regardless of the actual health of the regional economies.

This is relevant to the extent that governments rely on monetary policy (interest rates) rather than fiscal policy (government taxation and expenditure) to control the economy. While fiscal policy can be "regionalized" (targeted to withdraw spending from overheating regions or to inject it into depressed regions), monetary policy cannot.

To the extent, therefore, that fiscal policy does not successfully stabilize the economy of central Canada, the regional economies will bear the extra burden of an inappropriate monetary policy. In particular, the regional economies will pay part of the price for overheating in the centre. At least in the short-run, the centre will grow at the expense of the regions if fiscal policy does not prevent the centre's economy from overheating.

Greater Regional Input into National Policies

In discussing the limited impact of regional development initiatives, Polese (page 28) argued:

> "It must also be pointed out that direct (explicit) regional policies, such as those implemented by DREE, or more recently by DRIE, form only a small part of the total "tool kit" of programs and policies at the disposal of the federal government and the provinces. The combined impact of other economic and social policies has certainly been much greater in shaping the spatial configuration of the Canadian economy. A full-blown regional development policy for Canada would take into account the regional consequences of all federal and provincial programs."

He then qualifies this by stating:

> "...but it appears entirely unrealistic to ask all programs to subordinate their goals to regional policy objectives. Governments will necessarily pursue policies with conflicting goals."

The point remains, however, that national policies have had a profound impact on the distribution of economic activity in Canada. While we argued that the national levers of economic development are less effective than formerly, and we are also arguing for a transfer of discretionary policy down to the regional level, it will still be the case that important "framework" policies must be developed at the national level - for example, in international trade, transportation, and telecommunications. If we are correct in prescribing greater regional responsibility for economic development, it will be necessary to give the regions a greater explicit voice in the design of these national policies.

III. Response: Improving Canadian Economic Performance

A set of proposals that respond to the issues identified above will be outlined in this section. The modifications proposed fall under three headings:

1. Restructuring the approach to economic development;
2. Measures to promote prudent financial management;
3. Strengthening regional input into national policies.

The measures proposed go beyond modifications of policy and require, rather, constitutional and/or institutional adjustments.

1. Restructuring the Approach to Economic Development

In Section II.1 the case was made that a new approach to economic development should incorporate the following elements:

i. a transfer downwards, as much as possible, of discretionary decision making with respect to the allocation of resources to particular types of support;

ii. a shift in emphasis from promoting outputs through industry - or firm-specific protection and subsidies to promoting particular types of inputs through support for R&D, education and training, and infrastructure; and

iii. constraints on beggar-thy-neighbour policies among provinces.

How could the governing structure of Canada be modified to encourage these changes?

At first glance, it may appear that these elements are contradictory and irreconcilable in any particular constitutional model. In standard constitutional terminology, i. is clearly "decentralizing" while iii. is clearly "centralizing". Element ii. would also appear to call for more centralization if it is clearly felt that such a shift in emphasis is required at the national level.

The elements are not so irreconcilable if we realize there are really two aspects of the reorganization called for. One is the assignment of discretionary decision-making power; the other is the establishment of a set of rules within which that discretionary decision making will take place. From this perspective, what is being called for is a decentralization of decision making with respect to discretionary spending, but within a set of rules, or constraints, that strengthens the common market and leads governments to promote economic development through support of inputs rather than outputs.

Decentralization of Decision Making

To achieve the desired decentralization of decision making, it is proposed that the division of powers in the Constitution be redefined so that the following jurisdictional areas are defined as being ones of federal-provincial concurrency with provincial paramountcy (CPP):

- regional and industrial development;
- manpower/training; and
- research and development/science policy.

In general terms CPP means that both levels of government may operate in a particular area side-by-side unless a provincial government chooses to exercise its paramountcy - federal legislation would not be applicable, and the federal government would not spend any money in the particular province, with the province receiving financial compensation.*

*For a fuller discussion of CPP see Milne, David, "Equality or Asymmetry: Why Choose?" Paper prepared for the Business Council on National Issues Symposium on Canada's Constitutional Options, 1991, pp. 27-31.

Adopting a CPP approach allows for considerable flexibility. The notion that, in general, discretionary decision making should be pushed downwards as much as possible is not the same as saying that there is no role for the federal government in economic development. There will continue to be a role for the federal government in developing national frameworks, providing funding and (possibly) delivering services. Concurrency allows for this role.

The desirability of the federal role, however, will vary from issue to issue and, indeed, from province to province. Provincial paramountcy provides the mechanism by which this will sort itself out. In activities and in provinces in which it makes sense, provinces can exercise their paramountcy. Even where a province chooses not to "opt-out", the option to do so with compensation would provide greater assurance of federal responsiveness to regional needs and a "fair share" of federal resources.

The alternative to CPP would be to give exclusive jurisdiction to the provinces, with the federal government transferring the appropriate amount of tax room over to the provinces. While this would be consistent with greater decentralization, it would sacrifice the flexibility described above.

A Code of Economic Conduct

We have argued for a set of rules that strengthens the Canadian common market and leads governments to promote economic development through support of inputs rather than outputs.

The mechanism proposed for developing and enforcing that set of rules is patterned on recommendations put forward by the Macdonald Royal Commission in 1985. That Commission recommended that a federal-provincial Council of Ministers responsible for economic development be established. The Council would be responsible for, among other things, monitoring and assessing the state of the economic union and would serve as the vehicle through which to develop a "Code of Economic Conduct". The Code would "spell out the principles of the economic union, begin to identify and describe practices that are and are not acceptable, and provide mechanisms of enforcement". Initially, enforcement would be through public and governmental pressure, but after "Canadians have gained experience with the operation of the code, we should entrench its principles in the Constitution, and enforce the details of the code itself through some form of binding intergovernmental agreement which an expert commission appointed by federal and provincial governments would enforce."*

The proposal here is to follow the Commission's recommendation except to make explicit that, in addition to trying to achieve reductions in barriers to interprovincial trade and mobility of labour and capital, the Code aims at shifting the economic development emphasis away from industry- and firm-specific subsidies and towards support for research and development, education and training and infrastructure. These two objectives are, as pointed out in Section II.1, complementary. Making the second one explicit will take us further in the direction we want to go than merely eliminating practices that represent barriers to trade or to the movement of capital or labour. It is also necessary, as international trade negotiations and the movement towards integration in Europe have made clear, to constrain subsidies if the elimination of barriers to trade is to be achieved and sustained.

Given that the purpose of this paper is to concentrate on measures that require changes in the country's governing structure, it is fair to ask if the objectives here could not be achieved by individual governments merely making policy changes. If it is obvious that

*Royal Commission on the Economic Union and Development Prospects for Canada. Report, Volume Three. Ottawa: Supply and Services Canada, 1985, pp. 137-138.

governments should be changing their approach to economic development, will not they go ahead and do it, regardless of whether or not they sign an enforceable agreement with other governments to do so? The answer is that the evidence, both nationally and internationally, is that this cannot be relied upon, and that it often requires some kind of binding agreement to achieve the desired outcome.

There are two reason for this. The first is that some practices can provide a jurisdiction with a net benefit if it is the only jurisdiction that does so. For example, if Ontario requires that all beer sold there must be brewed there, while other provinces do not, economies of scale may well lead brewers to locate all of their capacity in Ontario, and Ontario would benefit. Other provinces will generally not sit by and let this happen - the other provinces will enact their own "brew-it-here-sell-it-here" policies - and the net result is an inefficient allocation of resources. Once we have arrived at that situation, it will generally not be rational for one jurisdiction to unilaterally abandon the practice. The practice will only be removed if there is a multilateral agreement to remove it.

The second reason for a binding agreement is that general rules that are agreed upon and have some enforceability can assist the public policy process in resisting actions that might be politically expedient in the short run. To illustrate the case here, suppose there is general agreement that the shift in emphasis from outputs to inputs is desirable. This general agreement may not result in any change, however, unless there is some mechanism to help governments resist the political pressures for industry- or firm-specific protection or subsidies. A binding Code of Economic Conduct would provide such a mechanism, just as the adherence to the General Agreement on Tariffs and Trade assists countries in sticking to generally agreed upon principles of international trade liberalization in the face of specific domestic pressures for protectionism.

Alternatives to a Code of Economic Conduct

There are two alternative approaches to using a Code of Economic Conduct as the mechanism to achieve these objectives - one builds on Section 121, the other on Section 91(2) of the Constitution Act, 1867.

Section 121 states that "All articles of the Growth, Produce or Manufacture of any one of the Provinces shall, from and after the Union be admitted free into each of the other Provinces." This section could be strengthened and extended to make it clear barriers to trade in services and non-tariff barriers (for example, provincial liquor policies) are prohibited. Parties adversely affected by provincial measures that were not consistent with this Section could seek remedy from the courts. While this would go some way in strengthening the Canadian common market, it is difficult to imagine that it would take us very far in dealing with the subsidies question.

Section 91(2) provides the federal government the power to regulate Trade and Commerce. An aggressive interpretation or expansion of this power might give the federal government the lever to strengthen the economic union in the way desired. Conceivably, it even could give the federal government the power to regulate subsidies. One would question, however, whether this approach would be feasible in the current round of constitutional negotiations. Furthermore, it would conflict with the notion advanced elsewhere in the paper that it is important to give the regions more voice in national policies.

2. Measures to Promote Prudent Financial Management

It was argued in Section II.2 that there were major costs arising from Canada's financial management over the past fifteen years. In particular, the debt/deficit problem in the country endangers the ability to sustain government programs and leads to higher interest rates. An urgent priority is to establish a pro-

cess that will solve the debt/deficit problem.

The root of the problem lies in the differing time horizons between what is prudent from a political point of view and what is prudent from a financial point of view - there is a divergence between the time horizon applicable to the "electoral cycle" and that applicable to the "debt cycle".

There is compelling evidence that measures to control deficits - higher taxes and restrained expenditures - are politically unpopular in the short-term. On the other hand, because of the cumulative and compounding effects of deficits, the benefits of deficit control take some time to bear fruit.

What we have labeled the debt cycle - the period of time it takes for the cumulative increase in debt to raise interest expenses enough to outweigh the initial increase in funds available for programs resulting from an increase in the deficit - is something like seven to ten years long. If a government decides to increase program spending by a specific amount and finances it by an increase in the deficit, it will be seven to ten years before annual debt-servicing costs will have eaten up all of that initial increase in financial resources. If a government decides to decrease program spending by a specific amount and reduce the deficit, it will be seven to ten years before the reduction in annual debt-servicing costs will exceed the initial decrease in spending.

This seven-to-ten-year debt cycle is contrasted with a political cycle that is never longer than five years, and gets steadily shorter each day after an election. It is not difficult to understand why deficit control in this environment is quite often the item on the political agenda that gets postponed. Even in a government committed to deficit control, decisions are bound to be be affected by concerns that controlling the deficit could promote the election of an opposition less committed to fiscal responsibility than itself.

A question arises as to why the voter does not transcend the difference between the debt cycle and the political cycle - that is, punish governments that are not financially prudent. The explanation probably lies in a combination of an information problem - for most voters government finance is something akin to a black box - and a credibility problem - the voter just does not believe that governments will use any extra tax revenue or any savings from budget cuts to reduce the deficit.

Whatever the reason, the current structure of governance seems inadequate to deal with the problem. What seems to be required is a constitutional remedy.

A Prudent Manager Rule

The particular remedy proposed here is to put into the Constitution a "prudent manager rule" that requires provincial and federal governments to maintain a structure of spending and taxation that is sustainable over the long run (see box on next page).

Three points merit discussion. First, this is not the same as a requirement to balance the budget. There are a number of reasons why a balanced budget requirement is not appropriate:

- when a large debt has been inherited from the past, some level of deficit will be consistent with fiscal sustainability in a growing economy;
- expenditures and revenues vary over the business cycle. It would be poor economic management to always require a balanced budget; and
- a balanced budget requirement would only encourage budgetary games, such as moving expenditures off-budget (witness the performance in the U.S. with respect to the Gramm-Rudman Bill, which is supposed to contain and eliminate the American deficit). This would actually work against prudent financial management.

Second, such a prudent manager rule does not represent a presumption in favour of small government. Whether a sustainable structure would require lower expenditures or higher

taxes is a question that properly should be dealt with through the normal political process. The only presumption that this rule makes is in favour of maintaining the potential for big government in the future.

Third, there may be some criticism of this proposal because it impairs parliamentary sovereignty. In a sense, however, it would reinforce the notion that Parliament cannot bind its successors - taking on large amounts of debt binds future parliaments in a very real, negative, sense.

To the extent that a prudent manager rule does constrain Parliament's ability to make or unmake law, it should be noted that this aspect of parliamentary sovereignty has already been violated with the Charter of Rights (albeit with the notwithstanding clause partial escape hatch). The comparison to the Charter of Rights is instructive, because the same question is applicable in both cases: are there interests of such value to society that justify constraints on the government of the day?

There is another similarity between the proposal here and the Charter of Rights. From a certain perspective, the prudent manager rule

WHAT IS A PRUDENT MANAGER RULE?

"PRUDENT MAN RULE. A rule of investment management that requires a fiduciary to make investments with that degree of vigilance and prudence which a reasonable and intelligent man would use with his own property. Under the prudent man rule a fiduciary is not an insurer or guarantor of the funds he invests, but is required to use the care and prudence that take into consideration the regularity of income desired and the preservation of the principal of the funds invested."*

The prudent man rule is an American legal concept relevant to persons managing funds in trust. While it does not apply directly to the management of government spending and taxation, making the analogy between the situation facing government and that facing a person responsible for managing and investing funds on behalf of beneficiaries highlights two points. First, the overall management of government spending and taxation should be recognized as a position of fiduciary trust. Second, this trust position should entail an obligation analogous to the requirement "to use the care and prudence that take into consideration the regularity of income desired and the preservation of the principal of the funds invested." The obligation being suggested here is that governments must maintain a structure of spending and taxation that is sustainable over the long run.

How Might it Work?

The challenging part of making a prudent manager rule operational would be in developing an appropriate yardstick with which to define financial prudence. One possibility might be to invest some office (the Auditor-General?) with the responsibility to do an annual and timely analysis of the particular government's overall spending and taxation plan from the point of view of whether or not it is sustainable over the long run. If it is concluded that the structure of spending and taxation is not sustainable, the government would be required to revise its fiscal plan through whatever combination of tax increases or spending cuts the government deems best.

This analysis will require a good deal of forecasting and judgement: is the economy operating above or below normal? are interest rates abnormally high or low? are the government's revenue forecasts reasonable? what portion of natural resource revenue is sustainable? are off-budget items properly accounted for? and so on. There will, of course, be a great deal of uncertainty about these forecasts, and any resulting conclusion about sustainability. Accordingly, the benefit of the doubt should go to the government of the day - only when a structure of spending and taxation is clearly unsustainable should the prudent manager rule be used to trump the duly elected government. Used judiciously, however, this mechanism might prevent the development of truly explosive debt/deficit situations, such as that of the federal government in the early 1980's, from developing. It would aiso enhance the credibility of government's commitment to controlling the current debt/deficit problem.

A Prudent Manager Rule for the Environment?

If the prudent manager rule proves to be workable in the context of government financial management, it might be applicable to other areas. One area might be that of environmental protection, which involves the same fundamental divergence between the short run and the long run, and an analogous concern about sustainability.

*Coughlin, George Gordon, Dictionary of Law New York: Barnes and Noble Books, 1982.

can be viewed as an elaboration of Section 15 (The Equality Rights Section) of the Charter. Unsustainable financial management represents discrimination on the basis of age - future governments will have to tax at higher rates and/or spend less on government-provided goods and services, and this is explicitly to the disadvantage of younger people.

While useful, this last point should not lead us to conclude that moving to prudent financial management is a type of "zero sum game" whereby the future gains at the expense of the present. There will be significant benefits resulting from the adoption of a prudent manager rule that will accrue in the present - lower interest rates.

Towards Lower Interest Rates

The adoption of a strong prudent manager rule would result in a significant lowering of interest rates. The three ways in which debts and deficits lead to higher interest rates discussed in Section II.2 would be reversed.

Of particular interest is the possibility that adopting a prudent manager rule would allow for a virtually painless reduction of deficits - that is, through a reduction of debt-servicing costs. Recall that one of the impediments to lower interest rates is investor scepticism about the long-run commitment to low and stable inflation. A commitment to fiscal prudence would be an important first step towards reducing this scepticism - solving the debt/deficit problem removes one of the major reasons why a government at some point in the future might wish to promote inflation by monetizing the debt. By reducing the risk of this happening, the premium required to hold debt denominated in Canadian currency would be reduced. The Catch-22 situation described above would be reversed - lower interest rates would allow lower deficits which, in turn, would increase the credibility of the commitment to prudent financial management.

The critical component in bringing this about is the credibility of the commitment to prudent financial management - hence the need for a strong prudent manager rule embedded in the Constitution. A possible further step to increase the credibility of the commitment to low and stable inflation would be to establish the Bank of Canada at greater arms length from the federal government. By so doing, the fear that the Bank may be subject to political pressure in the future to inflate would be reduced further. International evidence suggests that a more independent central bank leads to lower inflation (see box on next page).

Establishing a more independent Bank of Canada would require, at a minimum, revisions to the Bank of Canada Act which:

- redefine the objectives for the Bank; and
- establish a mechanism for choosing the Board of the Bank that would formally isolate it from political pressures. The key points here would be to have members of the Board appointed for periods (say, seven to ten years) which would exceed the length of the average parliament, and to have the appointments done on a staggered basis so that a government could not "stack" (or threaten to stack) the board at any one point in time.

The possibility of establishing a Bank of Canada at greater arms length from the federal government requires some discussion. First, it is not being suggested that the Bank is currently being pressured to inflate. The argument in this paper is that, if anything, the Bank's current policy is too restrictive. As the Bank Act is currently written, however, there is little legally or institutionally to stop some government in the future from directing the Bank to speed up the printing presses and inflate. The proposal to revise the Bank Act is directed at reducing the possibility of this happening, and thereby eliminating some of the risk premium that investors currently require to hold financial assets denominated in Canadian dollars.

Second, it is important that the objectives established for an independent Bank be care-

fully chosen. While an objective of low and stable inflation is important, it was argued above that there should be another consideration as well. For a small trading economy like Canada it is at least as important, in an era of globalization, to keep the purchasing power of the domestic currency relatively stable vis à vis the currencies of its major trading partners.

Third, it should be made clear that dealing with the debt/deficit problem is of more importance than establishing a more independent central bank. Without a solution to the debt/deficit problem, an independent monetary policy will not be sustainable over the medium to long term.

The Effect on Regional Development

In Section II.3 the problems arising from the situation where fiscal policy does not stabilize the central Canadian economy were examined. In particular, it was argued that the regions will bear the burden of inappropriately high interest rates when fiscal policy does not prevent the central Canadian economy from overheating. Imposing a prudent manager rule upon provincial governments would reduce this problem significantly.

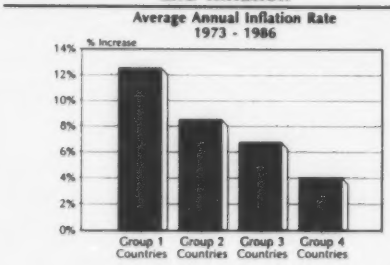
If provincial governments were to have a prudent manager rule imposed upon them, this would require governments responsible for provincial economies that are overheating to set up "rainy day funds". Revenues generated by a cyclical upturn will not be sustainable, so it would be imprudent to spend all of that additional revenue.

Alberta and Saskatchewan set up such rainy day funds in the 1970's with their Heritage Funds (though it might be argued that not enough was put into such funds). Ontario did not do this in the 1980's. The result was that

CENTRAL BANK INDEPENDENCE AND INFLATION

Experience shows that the freer a central bank is from government interference, the lower is the rate of inflation. The figure below, based on a study by Alberto Alesina,* shows how countries with more independent central banks have, on average, lower inflation rates. Countries are grouped according to an index of central bank independence, taking into account characteristics such as the formal institutional relationship between the central bank and the government (for example, who appoints the head of the bank), the presence of government officials on the board of the bank, and the existence of rules forcing the central bank automatically to print money to finance budget deficits. The countries whose central banks are the least independent had an average inflation rate of 12.5% over the period of the study (1973-1986); the countries whose central banks were the most independent had an average rate of 4%. Moreover, countries with freer central banks also tended to have lower rates of unemployment. This fits the proposition that a credible commitment to low inflation allows inflation to be contained at a smaller cost in terms of lost growth and jobs.

Central Bank Independence and Inflation



Group 1: Countries with the least independent central banks; Italy, Spain, New Zealand, Australia.

Group 2: Countries with weakly independent central banks; U.K., Finland, France, Denmark, Sweden, Norway, Canada, Belgium, Holland.

Group 3: Countries with strongly independent banks; U.S., Japan.

Group 4: Countries with the most independent banks; Germany, Switzerland.

*Alesina, Alberto, "Politics and Business Cycles in Industrial Democracies". Economic Policy, no. 8, April 1989.

This box was adapted from: The Economist, March 2, 1991.

monetary policy was tighter than it otherwise needed to be. The irony is that Ontario itself would be in better shape today if it had been forced to set up such a rainy day fund (or, more correctly, to retire some of its existing debt). The excesses of its boom would have been reduced, and it would have been in stronger finacial shape to fight the current recession. (Indeed, it might be argued that the "made in Canada recession" was a direct result of the Bank of Canada's reaction to the overheating of the Ontario economy.)

3. Strengthening Regional Input into National Policies

In Section II.3 we argued that national policies have significant effects on the distribution of economic activity and, if the regions are to have greater responsibility for economic development, they must be given a greater explicit voice in the design of national policies.

Related to this is the need to make a distinction between national and federal policies. Not all national policies need be the exclusive product of the federal government - national issues will transcend a federal government under any conceivable division of powers.

Taken together, these two points suggest the need for a formalized mechanism for federal-provincial decision making in selected areas of economic management. This is certainly not a novel idea, having been made by many others over the past twenty-five years, and the actual mechanics are not all that important for the purposes of this paper.*

In general terms, what is envisioned is that a Council of Ministers would have real decision-making powers. It would be made up of the federal government and each of the provinces. A qualified majority (eg. federal government and two-thirds of the provinces making up fifty percent of the population) would be needed to make a specific decision within an area assigned to it. A brief scan of a few of the areas where this mechanism would be appropriate follows.

The Canadian Common Market

The Code of Economic Conduct discussed in Section III.1 is an important example of the need for an integral provincial role in developing national policy.

International Trade Policy

Another area of policy which requires a formal provincial role is the negotiation of international trade agreements. There are significant regional effects of international trade policy, and this should be addressed explicitly in national decision making. Furthermore, with the general decline in the significance of tariffs in international trade, the measures dealt with in international trade agreements are increasingly non-tariff barriers. This means that, increasingly, policies of provincial governments - areas such as provincial liquor practices, government procurement, and provincial securities legislation - will be on the table. An expectation that provinces will implement the changes negotiated would suggest a more explicit role for the provinces in preparing the Canadian bargaining position and in ratifying the final outcome.

What would be required here would be to formalize, as an explicit obligation, the regular consultation process that Ottawa held for the Canada-U.S free trade negotiations and the current round of multilateral negotiations, followed by the necessity of ratification by the Council of the final agreement. Ratification would entail a responsibility for the provinces to implement treaty obligations within their areas of jurisdiction.

While this might, at first glance, appear to weaken the federal government's ability to deal in international negotiations, it would actually strengthen Canada's treaty-making

* For a recent brief survey of some of the proposals made since 1965 see Jean Chevrier, "Proposal for a New Federation", in The New Federation, January/February 1991, p. 35.

ability. At present, the federal government's treaty-making power is somewhat ill-defined constitutionally, and provincial compliance with treaty obligations is uncertain. The changes proposed here would remove this uncertainty.

Telecommunications

While Ottawa has recently moved to affirm federal paramountcy in this area, there remain significant provincial interests - for example, the Manitoba and Saskatchewan Government Telephone systems and Quebec's overall concern with communication policy. Accordingly, this is another area that might lend itself to the type of national decision making being proposed.

As an example of what might evolve here, it may be reasonable for the CRTC to fall under the jurisdiction of a joint federal-provincial body, rather than the federal government.

Bank of Canada Accountability

In Section III.2 the possibility of a more independent Bank of Canada was discussed. It might be reasonable to have the Council ratify federal appointments to the Bank's Board. The Governor of the Bank might also be required to appear quarterly before the Council to defend monetary policy. It should be clear, however, that we are not suggesting that the Bank be the creature of the Council.

IV. Concluding Remarks

The starting proposition of this paper was that major improvements in Canada's economic performance could be achieved through changes in the way the country is governed on economic matters. To establish what particular changes were called for, we first defined the major impediments to better economic performance. We then proposed a set of changes to the "governing architecture" of the country that would help in removing those impediments.

The problems facing the Canadian economy are interrelated. They reinforce each other in such a way that it almost seems as if we are facing the economic equivalent of gridlock. High interest rates and exchange rates severely damage the short-run competitiveness of Canadian industry. The interest rate problem cannot be solved unless the debt/deficit problem is solved. Debt service costs are of such a magnitude that it is difficult to see how deficits can be reduced without lower interest rates. A more competitive Canadian economy would generate more wealth and greater tax revenues. Stronger competitive performance will require more (or at least smarter) investments in education and training, research and development and infrastructure. The changes proposed mirror this interrelatedness.

The economic perspective is just one from which the constitutional question should be examined. It is important to pursue a number of other perspectives. What common values do we wish to reflect in our constitution? How shall the different Canadian communities be given voice? How can our First Nations find a just definition of their rights? How can we best protect our social programs in a constitutional context? Can protection of the environment be given a constitutional basis? Do human rights need to be further elaborated and protected?

We should not underestimate, however, the extent to which our ability to generate and sustain a high level of economic performance will condition the sense of generosity which we bring to these other questions.